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Macroeconomic policy questions: financing of development, including net transfer of resources between developing and developed countries

Towards a stable international financial system, responsive to the challenges of development, especially in the developing countries

Report of the Secretary-General**

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** The present report was submitted after 3 July 2000 owing to the extensive consultation process that was undertaken, as requested in para. 21 of General Assembly resolution 54/197, which took one month longer than expected.

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I. Introduction

1. The present report is submitted in response to General Assembly resolution 54/197 of 22 December 1999 and draws upon the analysis and cooperation of various components of the United Nations system, including the Department of Economic and Social Affairs of the United Nations Secretariat, the United Nations Conference on Trade and Development (UNCTAD), the regional commissions, the International Monetary Fund (IMF) and the World Bank.

2. Section II of the report summarizes recent trends in global capital flows, while sections III-V examine the main actions taken and concerns raised on issues addressed in General Assembly resolution 54/197.[1] Section VI, which concludes the report, contains a response to the request in that resolution that the present report propose an agenda for a strengthened and more stable financial system.

II. The trend in capital flows to developing and transition economies

3. Net financial flows to developing and transition economies in 1999 continued the contraction that had begun with the onset of the East Asian crisis in 1997 (see table). However, net flows in 2000 are expected to begin to increase. Aggregate financial flows in 1999 can be characterized by a significant decline in official financing and subdued private flows, with the latter having recovered only marginally from the sharp drop in 1997-1998. The lower level of net official flows was due not only to the end of emergency lending, but also to repayment of official loans by a number of crisis-affected countries.

4. While the high degree of variability in official flows, which can be seen in the table, is largely a reflection of waves of counter-crisis lending by IMF, the surge in official lending in 1997 and 1998 also included crisis-related lending by multilateral development banks and bilateral lenders and donors. Barring a new emergency, no substantial rebound is foreseen in the near term in official flows. In particular, official development assistance (ODA) is expected to increase only slowly and thus remain at depressed levels. Improvement in aid flows is contingent on strengthened confidence of donors in the efficacy of their aid programmes in raising economic growth and reducing poverty.[2] Donor reluctance to raise aid flows has been paralleled by slowness in approving the funding for targeted debt relief for the heavily indebted poor countries.[3]

5. Meanwhile, private investor sentiment towards emerging markets has begun to improve, based on stronger economic performance and improved external balances in a growing number of countries. As a result, the "risk premium" built into the cost of external credit fell substantially in late 1999 and the first half of 2000 for these countries and the flow of credit to emerging market economies as a whole began to rise. In fact, total bond, equity and loan flows in the first quarter of 2000 were more than half the flows in all of 1999, according to information supplied by IMF. The leading components of the increase in aggregate private flows appear to be portfolio and direct investment. Direct investment remains the largest net source of external private capital for these countries, although a large part of this reflected changes in ownership of capital (namely, mergers and acquisitions), rather than new investment.

6. On the whole, however, private financial flows remain substantially below those prior to the East Asian crisis. This is an indication that there is room for aggregate financial flows to developing and transition economies to grow significantly, although it is highly desirable that any resurgence in flows be spread among many more countries, particularly in Africa, which has had especially low overall levels of direct investment, portfolio and banking flows.[4] Before, private flows went mainly to a few countries whose rapid intake left them with unsustainable foreign exchange obligations once investor sentiment soured.

Net financial flows to developing and transition economies, 1990-1999

(Billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Developing and transition economies										
Total net flows	66.9	144.9	133.8	189.3	139.7	238.6	216.3	171.1	119.8	83.5
Net private capital flows	43.8	110.4	112.6	172.1	136.3	226.9	215.9	147.6	75.1	80.5
Net direct investment	18.5	31.6	35.4	59.5	84.0	92.6	113.2	138.6	143.3	149.8
Net portfolio investment[a]	15.7	27.1	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3
Other private flows[b]	9.5	51.7	21.1	28.3	-57.3	97.4	24.9	-43.9	-76.7	-92.5
Net official flows	23.1	34.5	21.2	17.2	3.4	11.8	0.4	23.5	44.7	3.0
East and South Asia										
Total net flows	25.5	45.8	31.1	65.9	74.3	111.5	107.8	20.2	-14.9	-28.0
Net private capital flows	19.8	34.9	20.8	57.4	67.5	104.9	104.1	-1.4	-42.6	-27.1
Net direct investment	9.2	14.5	15.7	33.9	47.1	46.6	53.1	55.5	58.3	49.9
Net portfolio investment[a]	-2.4	1.2	9.0	21.8	11.8	14.2	12.9	3.5	-17.9	-5.6
Other private flows[b]	13.1	19.2	-3.9	1.7	4.7	44.1	38.1	-60.3	-82.9	-71.3
Net official flows	5.6	10.9	10.3	8.5	10.7	6.5	3.7	21.6	27.7	-0.9
Latin America and the Caribbean										
Total net flows	17.3	26.8	53.8	67.3	45.8	61.3	67.5	81.9	76.1	57.7
Net private capital flows	13.7	24.1	55.6	66.8	49.4	53.2	72.2	85.5	70.0	54.1
Net direct investment	6.7	11.3	13.9	13.4	23.1	24.7	39.5	53.1	56.1	63.6
Net portfolio investment[a]	17.5	14.7	30.4	44.0	66.7	3.0	41.0	19.2	14.7	10.6
Other private flows[b]	-10.5	-2.0	11.4	9.4	-40.4	25.5	-8.4	13.2	-0.8	-20.1
Net official flows	3.6	2.7	-1.8	0.5	-3.6	8.1	-4.7	-3.6	6.1	3.6
Africa[c]										
Total net flows	6.7	9.7	6.4	4.5	10.6	18.2	12.0	15.4	14.1	16.4
Net private capital flows	-4.6	2.0	-4.0	-1.8	2.9	10.9	7.5	16.7	11.5	14.8
Net direct investment	1.2	2.1	0.6	1.9	2.3	2.2	4.8	7.4	5.2	9.6

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Net portfolio investment[a]	-1.2	0.4	1.9	1.0	2.0	1.4	1.3	3.7	4.3	4.4
Other private flows[b]	-4.6	-0.5	-6.4	-4.7	-1.4	7.3	1.4	5.6	2.0	0.9
Net official flows	11.3	7.7	10.4	6.3	7.7	7.3	4.6	-1.4	2.5	1.6
Middle East and Europe[c]										
Total net flows	6.6	68.7	36.7	31.0	14.9	12.8	14.1	23.2	21.4	25.3
Net private capital flows	12.6	64.9	38.0	28.7	6.0	13.9	15.2	24.0	22.0	27.1
Net direct investment	1.7	1.3	1.1	4.3	6.1	5.5	2.1	2.9	2.7	3.3
Net portfolio investment[a]	1.8	10.8	14.9	8.8	9.0	5.0	3.5	5.0	0.2	10.2
Other private flows[b]	9.1	52.8	22.0	15.7	0.8	3.3	9.6	16.0	19.1	13.5
Net official flows	-6.0	3.8	-1.3	2.3	-1.1	-1.2	-1.1	-0.7	-0.5	-1.8
Economies in transition										
Total net flows	10.8	-6.1	5.9	20.6	-5.8	35.0	14.9	30.4	23.2	12.1
Net private capital flows	2.2	-15.4	2.3	21.0	4.5	44.0	17.0	22.8	14.2	11.6
Net direct investment	-0.3	2.4	4.2	6.0	5.4	13.7	13.7	19.7	21.0	23.5
Net portfolio investment[a]	0.0	0.0	0.1	8.7	20.0	13.3	19.2	21.5	7.2	3.7
Other private flows[b]	2.5	-17.7	-2.0	6.3	-21.0	17.1	-15.8	-18.5	-14.0	-15.6
Net official flows	8.6	9.3	3.6	-0.4	-10.3	-9.0	-2.1	7.6	9.0	0.6

Source: International Monetary Fund, The World Economic Outlook Database, 2000.

[a] Including portfolio debt and equity flows.

[b] Including primarily short- and long-term bank lending and may include some official flows owing to data limitations.

[c] International Monetary Fund country groupings differ from those of the *World Economic and Social Survey*.

III. Policy in industrialized countries and the international economic environment

7. General Assembly resolution 54/197 emphasized the importance of an enabling international economic environment for financial flows for development. In fact, global economic and financial conditions improved significantly in the course of 1999. Economic recovery is broadening to more countries in 2000 and is strengthening in several major areas of the world. As a result, global economic growth is returning to the levels attained in the mid-1990s. These growth rates might be sustained over the next few years, although there are several risks to the realization of such an outcome.[5]

8. In particular, an unbalanced pattern of growth among the United States of America, Europe and Japan has resulted in current-account imbalances and exchange rates that appear difficult to sustain. The largest imbalance is that of the United States. Its trade deficit reached about 4 per cent of gross domestic product (GDP) in 1999, and has been growing since. Japan and Western Europe, on the other hand, continued to have trade surpluses. These imbalances coincided until 2000 with strongly rising prices in equity markets in the United States. The latter attracted massive capital inflows, which not only financed the United States current-account deficit, but also kept the exchange rate of the dollar high.

9. Meanwhile, in Japan, several years of recession or little economic growth, coupled with efforts to spur recovery with large public spending programmes, have led to the accumulation of substantial government debt, while the recovery in both private consumption and private investment remains fragile. At the same time, the financial sector in Japan continues to absorb the impact of the domestic financial difficulties of the 1990s. Thus, the banking system is slow to expand lending and the corporate sector is slow to take on new borrowing. As economic expansion in the rest of the world continues to pick up, however, these conditions are expected to ease.

10. Policy makers in the major industrialized countries have sought with success thus far to ensure that the adjustment of the imbalances among the major countries unfolds smoothly. They have applied a sequence of frequent, moderate adjustments of national monetary parameters, keeping an eye on policy-making by major country partners. The objective has been to slow the growth of the United States economy, with minimal adverse effect on Europe or Japan, while avoiding an inflationary build-up in any of these centres. In this regard, recent research suggests that the potential rate of non-inflationary growth of a number of developed economies has risen.[6] Thus, the fact that policy makers may not need to tighten monetary policy as early or as much as in previous episodes of comparably strong growth of demand, would make it easier to avoid unnecessarily sacrificing output and employment, or the growth of world trade and international financial flows.

11. One aspect of an uncontrolled adjustment of imbalances that the authorities of key-currency countries have sought to avoid is sharp changes in their exchange rates. Avoiding such instability of major currency exchange rates is also important to third countries, which carry out the bulk of their international transactions in these currencies.[7] Since the collapse of the Bretton Woods system of exchange-rate management in the early 1970s, economists and policy makers have debated how to regain a greater measure of stability of key-currency exchange rates. Opinions still differ widely and the end to the debate is not in sight. The difficulties are economic, financial and political (for example, more intense intergovernmental cooperation is required for exchange-rate systems that are closely managed, as European experience attests).

12. In the current system, exchange rates of the major currencies fluctuate in response to changes in supply and demand, which are increasingly determined by international private capital flows, especially short-term flows. These, in turn, are influenced by monetary policy in the major countries. While the monetary authorities in these countries are in regular contact and seek to avoid exchange-rate instability, their primary focus is on domestic economic conditions. Consequently, policy makers in developing and transition economies continue to face potentially large exchange-rate fluctuations among the world's major currencies. However, enhanced multilateral surveillance, being from a global perspective, might raise the saliency of the possible international consequences of developed-country policies (see sect. IV.A below).

13. Finally, as General Assembly resolution 54/197 implicitly recalls, developed countries, like developing and transition economies, face structural adjustment imperatives for enhanced stability and growth. What is unique here is that the structural reform efforts of the developed countries can have global consequences. In particular, there are global as well as domestic reasons for an accelerated opening of the protected sections of developed-country markets to foreign trade, including granting full access to the exports from the least developed countries, for example, agricultural goods, textiles and clothing. Further integration of some of the developing countries into the global trading system is contingent on improved access to developed-country markets. This should be part of a broader process of creating greater opportunities for expanding developing-country exports, which also strengthens the capacity of developing countries to import and to service capital inflows from international financial markets.

IV. Reform of the international financial system

14. To withstand financial shocks, a national financial system needs sound banks and other financial institutions, good management of risk by lenders and investors, and effective liability management by borrowers. Because "market failures" are inherent in finance, market processes left to themselves will not produce strong financial systems.[8] Thus, one cornerstone of a sound financial system is effective supervision, based on adequate financial information and transparency of both public and private sectors. As financial institutions and markets mainly reside within individual national borders, their supervision is chiefly the responsibility of national authorities. However, the extent of international financial integration means there is now also a need for multilateral oversight of financial market supervision, as well as more intensive monitoring of international capital flows, the latter being intimately related to traditional surveillance of the balance-of-payments and exchange-rate policies by IMF.

15. To make these principles operational, several international bodies are developing and fostering the implementation of standards of sound practice on the part of Governments and the financial sector. However, as even the most robust financial systems would remain susceptible to financial crises, agreed procedures are needed for handling them. The following sections review progress over the past year in these various dimensions of the reform of the international financial system and highlight some remaining concerns and proposed solutions.

A. Bolstering oversight through transparency and the flow of information

16. The primary agency for multilateral oversight of the international monetary and financial system is IMF, both in its annual "Article IV" surveillance of countries' macroeconomic and external payments situation and in the monitoring of negotiated programmes of balance-of-payments adjustment. The Fund also sets the standards that guide its surveillance and related norms, for example, in the statistical area. In this regard, IMF has helped to boost international financial transparency of Governments through establishment of its Special Data Dissemination Standard, with which a growing number of countries that seek access to financial markets are complying. It has similarly been developing the broader General Data Dissemination System for use by all member countries. It has also agreed to promote voluntary compliance with various codes of macroeconomic policy-making — in particular, the Codes of Transparency in Monetary and Financial Policies and the Fiscal Transparency Code — as well as codes endorsed for financial sector regulation. A number of countries have volunteered to participate in the joint IMF/World Bank Financial Sector Assessment Programme, which is outside the usual surveillance exercises. Moreover, there have been significant improvements in the transparency of the Bretton Woods institutions themselves, in particular as regards information made available to the public. With respect to surveillance, for example, IMF now actively encourages countries to permit it to release formerly confidential Executive Board assessments in the form of Public Information Notices and on a pilot basis it has supported voluntary release of Article IV staff reports.

17. At the same time, concerns have been raised about the growing scope of multilateral surveillance of developing and transition economies. One concern is the possibility of overloading the capacities of national authorities. The human-time and financial cost of

governmental compliance with new expectations on coverage, frequency and timeliness of information collection warrants assessment. Flexibility is needed with regard to the period expected for implementation. In addition, surveillance should be attuned to individual country requirements. One proposal in this regard is that IMF generally limit its surveillance to core macroeconomic and financial issues (such as interest rates, exchange rates, fiscal balances and the sustainability of financial flows), and monitor non-core variables only where they have macroeconomic relevance.[9] The aim is for surveillance not to enter into domestic economic activities that are not central to the Fund's mission, while realizing its essential role of advising national authorities of macroeconomic fragilities so that timely corrective actions may be taken.

18. Meanwhile, it has been argued that multilateral surveillance of major developed countries should be intensified. As discussed in section III above, economic policies of the major industrialized countries have significant impact on most economies and may be the source of systemic shocks and vulnerabilities. These countries have been called upon to pay particular attention to the coherence of their policies with global objectives and priorities. Among other issues, it has been suggested that IMF should give greater weight in its assessments of the major countries to the implications of their macroeconomic developments and policies for their exchange rates and financial asset prices.

19. A related concern is being able to monitor financial movements, particularly the short-term credit flows that can become highly volatile. One difficulty is the quality of financial data. As currently compiled, data on balance of payments, international investment position and flow of funds are far from complete or timely. One particular concern is the data on "over the counter" derivatives, which are customized, short-term financial instruments that are widely used, especially in developed economies. However, a working group of the Group of 10 (G-10), an industrialized country grouping, decided in November 1999 not to proceed further in studying the feasibility of collecting and disseminating data on aggregate positions in the foreign exchange market. According to many experts, the initiative could have helped smaller countries to better understand the situation as it affected their own currency markets.

20. An axiom of reform in recent years is that markets work better when there is greater transparency all around, including on the part of major private financial institutions. However, private sector disclosure practices have not kept pace with the rapid changes in financial institutions' business activities. In this regard, harmonization of accounting standards would ease the task of regulators and market participants in analysis and comparison of the major internationally active financial institutions on a consistent basis.

21. In fact, harmonization of accounting standards is an issue across the corporate spectrum. Work is under way, in this regard, in the International Accounting Standards Committee, a private body formed of 142 professional accounting organizations in 101 countries, and in other accounting associations. At the same time, the merger or development of associations among stock markets in different countries has given a new impetus to international harmonization in accounting and reporting. Here, the norms of the partner country with the stricter standards will perforce become the norms of firms listing on each merged or associated stock exchange.

22. Generally, progress in accounting and other transparency-related areas has been slow. Difficulties commonly cited are the obtaining of compliance by market participants, the infeasibility of producing data in a timely manner, and the substantial costs to be borne by the private sector and/or Governments. The question of market and official incentives for standards implementation thus remains to be resolved.

23. In sum, there have been informational and institutional improvements that permit stronger oversight, although important gaps remain. Were they filled, the timely publication of comprehensive and accurate data on countries and companies would also allow more precise private sector assessments of financial risks. Improved information would thereby have a positive effect on the performance of international capital markets. Many analysts remain sceptical, however, that increased transparency necessarily leads to increased stability, or that it will prevent future crises. This depends on how investors and creditors respond to information as it becomes available.

B. Strengthening financial regulation and supervision

24. Governments directly operate or regulate their financial sectors, inter alia, because private financial actors are prone to take excessive risks that can have high economic costs. International financial integration has made financial institutions and Governments sensitive to the differing extent and quality of national regulation and thus of prudential protection. It has also prompted international efforts to design common regulatory standards. The process is most advanced in banking, where the Basel Committee on Banking Supervision was established by the G-10 some 25 years ago, with links to the Bank for International Settlements (BIS), which provides its secretariat services. The Committee seeks to establish regulatory standards that its member countries then interpret and adopt as domestic regulations. Increasingly, these standards have become global norms.

25. In part prodded by the financial crises of the 1990s, the Basel Committee has been seeking to update the Basel Capital Accord of 1988, which set common capital-adequacy guidelines for regulators to require of the internationally active banks that they supervised. The period for consultation on the Committee's proposals for a new capital-adequacy framework ended on 31 March 2000 and a set of recommendations incorporating the comments and inputs received will be published in 2001. This framework will affect, first of all, the developed countries whose authorities participate in the Basel Committee (and this time not only for their internationally active banks), but it is expected to become a global standard as well. Indeed, a "second pillar" concerning principles of supervisory review was included in the draft framework. That pillar had not been deemed necessary when the original Accord was prepared for the G-10 countries in the 1980s.

26. Official regulations are a last line of a country's defence against imprudent behaviour in its banking system, in that they specify minimum acceptable safeguards and periodic inspection by regulators. The new framework looks for assistance in oversight of the financial sector from "market discipline" (that is to say, changes in market pricing of a bank's own securities and interest rates required to attract deposits). A "third pillar" of the proposed Basel framework thus calls for more extensive public disclosure of the financial condition of regulated entities. This means that, even more than before, internationally comparable indicators, let alone standards of accounting and reporting, are needed.

27. Most centrally, the new framework aims to more accurately distinguish degrees of credit risk (in other words, the probability that a borrower will default), and other risks (such as losses from exchange-rate changes) and to then better align regulatory requirements with underlying risks. Two approaches were followed in the proposed framework and both have engendered controversy. One approach views regulation as ensuring that banks follow sound practices, and so regulators would be asked to assess internal risk-management systems of banks. Banks with approved systems would be allowed to calculate the effective risk-weighted value of their portfolios of loans and other assets, according to approved rules, from which the capital requirement would be derived. This approach makes heavy demands on domestic authorities who have to draft the national guidelines to implement the framework, as well as on the technical capacities of regulators who are to visit the banks.

28. The other approach, which requires less technical sophistication to implement, is a modification of existing standard procedures. Here, a bank's portfolio of loans is divided into certain categories of risk, the loans in each of which are multiplied by a category-specific "risk weighting" and the results added. The required capital is then a specified fraction of this sum. Under current operations, loans to other banks in the member countries of the Organisation for Economic Cooperation and Development (OECD) are all treated as being of equally low risk. In the proposed modification, loans to similarly rated banks or sovereign borrowers, whether located in OECD or not, would receive the same risk weight. In addition, under the existing regulations, the risk associated with short-term interbank lending was underappreciated and this, too, would be changed in the revision.[10]

29. The most controversial aspect of this second approach has been the suggestion that assessments by credit rating agencies be used to categorize borrowers. These agencies function primarily to assess prospective bond issues by Governments and large corporations, as well as complex financing packages for large investment projects. This is a relatively small share of the universe of the clients of banks.[11] Moreover, credit rating agencies have had a limited and mixed record in

developing countries. Their assessments, it is argued, have tended to lag changes in market conditions, first encouraging excessive investment through over-optimistic ratings and then aggravating abrupt and huge capital outflows with negative assessments.

30. Whether or not credit ratings were used in bank regulations, there is a view that ratings agencies themselves warrant official oversight, which for the most part they do not now receive.[12] In this view, ratings should be transparent, in other words, determined by strict, objective criteria that are publicly known. However, some degree of judgement by the analyst making a rating seems unavoidable. Moreover, some of the criteria, including social and political considerations, are not quantifiable. Also, the agencies generally provide little guidance as to the relative weights they assign to each factor. As a result, the consistency and rationale — especially of sovereign ratings — have frequently been questioned.

31. The same forces of international integration that brought national banking regulators to seek common standards have brought about international efforts at norm-setting in other regulated segments of financial sectors. In the case of securities firms, the International Organization of Securities Commissions (IOSCO), a forum comprising both governmental authorities and self-regulating markets, has been developing principles and standards to protect investors and to reduce the potential for systemic risks, including prudential standards for risk management by firms that trade securities on member markets. IOSCO also cooperates with the Basel Committee in monitoring international financial derivatives trading.

32. Cooperation between different standard-setting bodies in financial regulation has been building for years. Besides the bodies mentioned above, it includes the International Association of Insurance Supervisors, which, like the Basel Committee, is housed at BIS. Even so, questions have arisen about ensuring coherence and consistency of regulatory approaches in all the various components of the financial sector, as to both norm-setting and monitoring implementation, and making best use of core competencies of different international bodies. For this reason, the Group of 7 (G-7) created the Financial Stability Forum (FSF) in February 1999. Also housed at BIS, it brings together the G-7 finance ministries, central banks and regulatory authorities, along with relevant international regulatory committees, IMF and the World Bank. Although the central banks of Australia, the Netherlands, Hong Kong Special Administrative Region of China and Singapore joined later, FSF is not yet a fully representative body. It does, nevertheless, seek wider participation in the ad hoc working groups through which it develops its recommendations.

33. The main output of FSF in its first year was three working group reports, which it endorsed in March 2000, on highly leveraged institutions (HLIs), in capital flows, and on offshore financial centres. The report on HLIs, in which there was considerable international interest, did not recommend direct regulation of currently unregulated financial institutions, such as "hedge funds", although this had been considered. Instead, it recommended stronger risk-management practices on the part of the counterparties to HLI transactions, enhanced regulatory oversight of HLI creditors (mainly banks) and greater public disclosure of their exposures by HLIs themselves.

34. Only time will tell whether these indirect measures are sufficient. Competitive pressures may lead again to a significant relaxation of risk management by these self-regulating firms. Moreover, even if individual HLIs comply with sound risk-management practices and do not breach their own internal limits on leverage and liquidity risk, they could collectively build up positions that might destabilize smaller markets. This suggests that monitoring is warranted at market level as well as at firm level. An additional dimension of concern is "fair play" in competition. Now, the regulatory system allows HLIs, whose investment activities and market impact are similar to those of their regulated competitors, to evade regulation only because of their different legal form and structure.[13]

35. Indeed, it has been argued that prudential standards should be raised or established for various types of non-bank financial institutions, as the risks they bear are increasingly similar to those facing regulated banks. In this regard, the imposition of some form of risk-based liquidity requirement on international institutional investors, including mutual funds, has been proposed. One consequence would be to reduce the need for them to engage in the rapid selling of security holdings into falling markets during periods of market stress, which aggravates the volatility of international capital flows.

C. Customizing prudential standards and their implementation

36. It is increasingly recognized that many countries will find it difficult to implement in the near future even a limited number of the new standards and regulations designed to strengthen domestic financial systems (banking, payments systems, securities and insurance regulation, as well as accounting, auditing and corporate governance). Many of these standards are themselves quite new, and thus are not well tested for robustness and relevance in the full range of domestic environments.

37. This is the case, in particular, for something as basic as the Core Principles of Effective Banking Supervision, which were drawn up as recently as 1997 by the Basel Committee. It was only in October 1999 that the Committee published a follow-up document, the "Core Principles Methodology", on how to interpret the Core Principles. As of March 2000, approximately 120 developing countries had endorsed the Core Principles. However, it is one thing to formally adopt the rules, but quite another to adequately implement them. Moreover, applying regulatory standards that largely grew out of practices in a small number of industrialized countries does not leave much room for consideration of institutional structures — or the social and developmental environment — of the full range of developing and transition economies.[14] It has also been argued that very often "headline regulations" have been enacted without the information needed to verify compliance or the enacting of incentives that might encourage financial institutions to provide the information voluntarily. Consequently, it is feared by some that compliance with hard-to-verify standards may in some cases be cosmetic.

38. A number of proposals have thus been put forward, including in consultations between the Basel Committee and groups of supervisors from developing countries, to modify further the regulatory approach in order to make prudential systems more suitable for developing countries. It has been argued, for example, that rules and regulations should be relatively simple, not highly dependent upon other components of the prudential system, and easy to verify and enforce. Those proposals include adopting very strict bank licensing, together with strengthening or reinstating reserve requirements. Other policy instruments that have been considered include asset-class restrictions and exposure limits, risk-based deposit insurance premiums and "speed limits" on the growth of bank lending, as well as reintroduction of ceilings on bank deposit rates.[15]

39. There is also the matter of implementation itself. It is typically discovered in the course of national implementation of any global standards that "one size does not fit all". Countries with different institutional histories will necessarily move towards effective adoption of specific standards at different speeds. It is thus important that multilateral mechanisms to assess how standards of financial oversight are being introduced take full account of the circumstances of the economy and the structure of the financial system, including its ownership pattern. The numbers of codes, standards and principles in the financial area are already overwhelming for a number of countries. As everything cannot and need not be done at once, the main context in which implementation should be assessed is that of the degree to which it encourages sound overall financial behaviour that is appropriate to a country's particular needs.

40. One aspect of the implementation challenge in strengthening regulatory capacity is adequate support for training. Where global standards are being applied, the expertise of those international bodies that have drawn up the standards should be available in the course of implementation. This was recognized, for example, in the decision taken in 1998 by BIS and the Basel Committee to establish the Financial Stability Institute (FSI). It seeks to promote better and more independent banking, capital markets and insurance supervision, based on the Core Principles. Initiatives such as this, which may be on a regional as well as a global level (see sect. V below), can draw upon core regulatory competencies as well as private sector expertise and resources in implementation of specific standards, first of all those developed by self-regulatory or professional associations.

41. In sum, the system of prudential supervision and regulation should reflect the state of market development, institutional preconditions affecting supervision, and the risk factors affecting banks. As markets evolve, the supervision system should evolve too.

D. Improving liability management

42. Stronger liability management on the part of the enterprise sector and government itself is increasingly seen as an important complementary element of financial crisis prevention. The strategy encompasses essentially two elements: encouraging borrowers to make greater use of lower-risk financial instruments and more closely monitoring the aggregate exposure and vulnerability of an economy to international debt crises.

43. Regarding the first element, there is broad consensus that borrowers should eschew excessive reliance on short-term debt and accurately measure the risk of their net financial positions. For example, they should realistically assess the chances of default of the financial institutions with which they hedged their risk.[16] There have also been recommendations to limit the use of "put options" in debt instruments. These are clauses in long-term credits that give the lender the right to an early repayment in case of some stipulated event. While this option lowers the perceived risk to the lender and thus the interest rate demanded, it can suddenly turn long-term debt into short-term debt.

44. Rather than "puts", there have been suggestions to add "call options" to new sovereign bonds and interbank credit lines. These would allow a debtor to choose to extend the maturity of its borrowing for a specified period of time at a predetermined additional interest rate if certain events were to occur. Such options would be exercised to ease pressure in the event of a liquidity crisis, although market suspicion that the option might soon be exercised could itself risk precipitating a crisis. In any event, call options are best seen in the context of mechanisms to "involve the private sector" in crisis prevention and resolution (see sect. F below). As of mid-2000, no call options have been embodied in loan agreements.

45. Another strategy is to foster the development of alternative sources of funds for borrowers. An attractive example is a domestic-currency bond market, which not only would be a source of long-term funds, but would also remove exchange-rate risk from the borrower. There would be no exchange-rate risk for domestic purchasers and any foreign purchaser of a bond would bear the exchange-rate risk. This has distinct advantages over conventional foreign-currency bank credits as a mechanism for channelling foreign lending into an economy. If there is a panic and bond prices fall, along with the exchange rate, the foreign bond holder has little incentive to sell the depreciated bond, as he quickly recognizes the loss in the sense that he reduces the value of the bond on his books owing to the accounting practice of "marking to market". In addition, if the borrower firm is solvent, it will continue to service the domestic currency bond, whose market price may well recover after the panic ends. A foreign bank creditor, in contrast, holding a foreign currency loan will not change the book value of the loan after devaluation until the borrower admits difficulties, and so the bank will try to sell or call the loan while it is still "good". This becomes a further capital outflow.

46. Although domestic bond markets are thus said to limit financial panics, the extent and duration of panics have their own logic and little can be said with full confidence. Moreover, well-functioning bond markets are not easily created. They require a strong infrastructure of corporate transparency and governance, an effective and fair securities trading system, and an effective clearing and settlement system so that investors develop the confidence to place funds in the securities offered. In some cases, enhanced regional cooperation can combine relatively small national markets into a deeper regional one.

47. With respect to liability management at the national level, the initial need is adequate monitoring, which entails estimating, first, the aggregate level of the debt; second, its currency composition and maturity profile; and, third, the composition by sector (public and private, bank and non-bank and so forth) Governments need accurate and timely data on these aspects of external exposure, as does the private sector.

48. The next concern at the level of national monitoring is identification of appropriate indicators of external vulnerability, such as the ratio of short-term debt to official reserves.[17] Indicators, however, are not without danger. They should not be applied in a mechanical manner, since their relevance as indicators of vulnerability depends in part on the nature of the country's exchange-rate arrangements and here, too, no hard and fast rules apply. Indeed, work is under way in IMF and the World Bank on defining sound practices in sovereign debt management, which may lead to more comprehensive recommendations.

E. Choice of exchange-rate and capital-account regimes

49. In the range of possible foreign exchange regimes along a continuum from completely fixed to fully floating, preferences have been shifting towards systems closer to either extreme, usually under the assumption that capital flows would be completely liberalized. This was in part a reaction to crisis experiences of a number of Asian countries that operated "managed floats" in a decontrolled environment. However, the more extreme systems may serve well in only a very limited number of situations. An irreversibly fixed rate can entail considerable costs when there is an external shock. All of the reaction in the economy must come through output and employment losses, as none of the reaction can be transmitted through nominal price changes of internationally traded goods. At the other extreme, purely market-determined exchange rates exhibit more volatility than is warranted by the underlying fundamentals, setting off undesirable output and employment fluctuations.

50. Moreover, the view that there should be no restrictions on capital flows or even that developing and transition economies should move quickly towards unrestricted capital flows has been challenged by the events of recent years in several emerging economies. While crisis countries had open capital accounts, countries that limited capital flows had some protection from contagion and less exposure to crisis to begin with. This said, controls, in particular on short-term flows, are best seen as part of a policy package that includes sound fiscal and monetary policy, appropriate structures and strong institutions. Also, Governments adopting a controls regime should have the capacity to administer it efficiently and fairly. Even so, adoption of controls often gives rise to a parallel or illegal foreign exchange regime that evades the controls. The less appropriate the overall policy package, the greater the leakage into the parallel regime. Indeed, controls cannot substitute for macroeconomic and structural adjustments that are needed, and there is substantial experience to show that the effectiveness of controls diminishes over time, in particular when needed policy adjustments are not addressed.

51. Various modalities have been conceived for capital controls. For example, supporters of capital controls often cite the experience of certain Latin American countries and, first of all, Chile, which in 1991 imposed disincentives in the form of non-remunerated deposits at the central bank on a broad range of short-term inflows (the controls are currently suspended). Other modalities can be conceived with similar effect. For example, a recent working paper by an IMF staff member argued that banks could collect a withholding tax on all private financial inflows, with credit and refund provision to relieve non-capital inflows from the tax.[18] Like the Chilean scheme, the tax would penalize investments more severely the shorter the holding period. Quantitative limits and higher capital and reserve requirements on the net foreign exposure of banks and other financial institutions have also been recommended. A policy that was more common in earlier years and might be revisited would limit foreign entry into domestic financial markets or segment these markets, for example, by offering separate classes of securities to domestic and foreign residents. Yet another approach would be to maintain a generally open capital account but to impose temporary controls on capital outflows in crisis situations, behind which corrective measures could be taken, as was the case in Malaysia in 1998-1999. In this approach, capital controls operate more in the nature of circuit-breakers than "sand in the wheels" of international finance.

52. There is thus a wide range of exchange-rate regimes and modalities for capital-account management from which to select, depending on the objectives of economic policy and the level of development. No single regime will be optimal for all countries and at all times. Governments should not, therefore, be pressed to adopt any particular form of exchange regime or degree of exposure to capital flows, especially the short-term flows that tend to be most volatile. The object, instead, should be to ensure a credible system that can be sustained. The international community should remain open to the choice by Governments of intermediate regimes and strengthen efforts to provide developing countries with thorough analysis of the relative merits of different options across the full spectrum of exchange-rate and capital-account arrangements.

F. Towards involving private creditors in crisis resolution

53. The international community is seeking to establish new principles to be followed in the event of a financial crisis. This may itself help reduce the incidence of crises, as financial actors come to understand better how they will be expected to share in the costs of crisis. Indeed, this policy thrust is partly a reaction to the early practice in the 1990s crises, when the official sector bore what is now regarded as a disproportionately large share of the burden of crisis resolution. There is a broad feeling, in particular, that foreign private lenders to private developing-country borrowers should not presume that in the event of a financial crisis the developing-country Government will take over the credit and make the lender whole. However, it has been difficult to go beyond just specifying that the private sector must play a larger role in crisis resolution.[19] The mechanisms to ensure that creditors have appropriate incentives to avoid a "rush for the exits" are still to be designed, although there are some broad principles.

54. At the most general level, the advantage is widely seen of inserting predictability into crisis-management efforts. In this regard, private sector involvement must be accepted as the rule, not the exception. Beyond this broad principle, however, guidelines are needed on how to divide responsibilities among the international community, the debtor authorities and private creditors. These guidelines — as yet unspecified — should be applied equally to different countries in a similar position. It is important to ensure the even treatment of all creditors and countries. To implement the guidelines, clear and systematic instruments and procedures should be identified. At the same time, the guidelines and procedures should retain some flexibility so they could be adapted to specific circumstances. Full automaticity in the decisions on private sector involvement could hardly be expected, especially as opinions will differ on a country's short-term financing gap and long-term sustainable level of debt. In other words, there should be appropriate balance between the element of judgement and "clear rules".

55. One suggested framework for private sector involvement employs a case-by-case approach, based on an assessment of a country's balance-of-payments situation and prospects of regaining market access. On the one hand, if a crisis country's financing requirements were deemed moderate and there were good prospects of rapidly regaining market access, it is thought that private sector involvement could be ensured through the catalytic role of official financing and domestic policy changes. This approach is that of a conventional IMF standby arrangement. On the other hand, if the financial requirement was large, prospects of regaining market access were poor and the debt burden was unsustainable, more concerted forms of involvement could be required. The crisis response process might begin with a Government-initiated but multilaterally sanctioned standstill on payments to foreign creditors. During this "breathing space", an IMF arrangement would be negotiated and burden-sharing arrangements worked out with the creditors. In this case, the precise form of involvement of the private sector would have to be fit to the individual case. Together, this set of principles is a useful start, but issues related to the underlying analytical judgements need to be resolved before these principles constitute an analytical framework.

56. An additional concern is establishing the mechanism by which creditor participation would be given effect. In earlier debt crises, advisory committees of creditor banks (the so-called London Clubs) were established to negotiate with the debtor Government a new schedule of interest and principal payments on unserviced bank loans. With the shift to greater use of bond financing, an increasing proportion of private debt was not subject to renegotiation. To remedy this, broader use of "collective action clauses" (CACs) in sovereign bond contracts has been suggested. At present, bonds written under the laws of New York State, which are the majority, require unanimity among bond holders to change the terms of the bond. Bonds written under British law, in contrast, specify the requisite majority for taking "collective action" to change the terms of the bond. Most Governments, however, have not introduced CACs, mainly out of concern about not lowering their reputation in the market. It has been suggested that one way to overcome this reluctance is for the G-7 Governments to introduce CACs as a standard feature in their own sovereign debt instruments. However, as of June 2000, only Canada, Germany and the United Kingdom of Great Britain and Northern Ireland had adopted CACs in their foreign currency bond and note issues. Other G-7 countries could follow this example.

57. Once CACs become common, procedures would still be needed to work towards a coherent and fair treatment of all the creditors and the debtor country. Most likely, the standard process, involving IMF in a coordinating role, the bank advisory committee and the Paris Club (for official loans), would be extended to include the bond holder committee.

58. A more ambitious approach would bring the claims of all the creditors together under an international bankruptcy court. The approach is based on the United States Bankruptcy Code (chapter 11 for enterprises and chapter 9 for municipalities and other public debtors). Once such a court accepted a case, it would appoint a supervisor to oversee the debt work-out. An alternative that does not require creation of a new institution is international agreement on a framework of key insolvency principles that IMF would administer, including a bankruptcy trigger mechanism.[20]

G. A toolbox of measures for emergencies

59. Even where agreement has been reached, many of the reforms discussed above will take many years to implement. Even then, vulnerability to excessive volatility will remain. Thus, for today and for the foreseeable future a set of policy tools needs to be at hand for use by countries to prevent and contain crises.[21]

60. Concerning preventive measures, there is much less opposition than in the period before the Asian crisis to "controls" in the form of policy-based disincentives to short-term capital movements. As noted above, they can be seen as part and parcel of the choice of exchange-rate regime.

61. Besides capital controls, the first government defence against the disruption arising from capital flow reversals is foreign currency reserves. It has been suggested that reserves should be at least equal to the amount of debt maturing within one year. Other factors proposed for determining reserve adequacy include current-account deficit, exchange-rate regime, variability of the balance of payments and the uncertainty associated with the measurement of short-term debt and reserves. There are also suggestions to share the burden of reserve holding with the private sector by requiring banks to hold more liquid foreign assets.

62. A related type of defence is to supplement reserves with an open credit line from foreign lenders to be drawn upon in certain unfavourable circumstances. The Government pays a commitment fee to a consortium of private international banks for the availability of the facility and receives the right to draw from it at a predetermined interest rate up to a pre-established limit. Such facilities provide access to supplementary liquidity at a lower price than that of holding an equivalent quantity of additional reserves.[22] Like large stocks of reserves, contingent credit and liquidity facilities can help inhibit a sudden contraction of credit. However, the use of these facilities has been very limited thus far. Only Argentina, Indonesia and Mexico arranged contingent credit lines before the Asian crisis and no country has done so since then.

63. In 1999, IMF introduced an international public sector version of such facilities, the Contingent Credit Line. The fact that no member country has availed itself of the IMF facility has suggested that it needs to be modified to impart much greater flexibility and to strengthen its preventive role through better integration with other precautionary arrangements. IMF has thus begun to consider revisions to the facility to make it more "user-friendly". However, potential users of the facility might still be concerned (as was the case with the private contingent facilities noted above) that application for it would in itself raise suspicions in the market that something was wrong. There are also concerns that, were a country taken off the list of qualified participants because it no longer satisfied the conditions for receiving liquidity support, this would almost certainly spark a crisis. A more nuanced system needs to be devised so that events are not misinterpreted by the markets.

64. One should also not lose sight of the important role played by conventional IMF lending programmes. One difficulty in arranging them is that Governments generally wait until an emergency situation arises and then considerable time is required to negotiate both the policy conditions and the financing package. One way to speed up the process is to restrict the negotiations to core macroeconomic policy variables, leaving structural adjustment concerns, which are in any case longer-term issues, for separate consideration, as under World Bank or regional development bank programmes.[23] However, even a narrower standby arrangement would take some time to negotiate. In certain situations, therefore, a standstill on foreign debt

servicing, coupled with emergency exchange controls, could be warranted as an interim measure, as noted in section E above.

65. There is, moreover, a further IMF option that could assist numerous developing countries that are pursuing sound policies (as per their Article IV surveillance reviews or implementation reviews of standby or other arrangements). In particular, countries that are heavily dependent on commodity exports are typically subject to wide variation in their foreign exchange earnings owing to international price swings. To assist such countries, the Compensatory and Contingency Financing Facility could be returned to its mode of operation in the 1960s and 1970s, when access to the facility was semi-automatic and there was quick disbursing for countries experiencing temporary shortfalls in commodity export earnings or excess import costs, in particular for food.[24]

66. The modalities of private and official liquidity provision discussed above presume a need for use by at most a few relatively small countries at a time. It is not clear that sufficient resources could be deployed to stem a broad panic that embroiled several countries more or less simultaneously, particularly if they included several large emerging economies. To quell such a crisis might require that large amounts of liquidity be quickly supplied to the crisis countries on a temporary basis by a "lender of last resort". The central banks of key currency countries could decide to lend their currency to the central banks of crisis countries against collateral in the borrowing-country currency (usually local government bonds). Depending on the number and size of countries affected, this could entail a significant unplanned increase in central bank holdings of the assets of distressed countries, which might inhibit the quick response needed. An alternative mechanism would be the temporary creation by IMF of a substantial volume of special drawing rights (SDRs), which, by pre-arrangement, crisis countries could swap on a guaranteed basis with key-currency central banks for their currencies. This mechanism would operate quickly and under multilateral control. The SDR emergency liquidity system would be activated in the event of crisis and later, when the danger of a systemic collapse had subsided, the inter-central bank credits would be unwound and the SDRs withdrawn. This would ensure that there was no permanent increase in unconditional liquidity. Knowing that a mechanism of this type existed could in itself strengthen investor confidence in the international financial system.

V. Systemic reform and confidence-building at global and regional levels

67. By the end of 1998, it was clear that economic and financial globalization in the 1990s had outpaced the capacity of the institutional framework in and among nations to manage it. The economic catastrophe in East Asia and the Russian Federation in 1997 and 1998 and the near meltdown of United States financial markets in the third quarter of 1998 profoundly shook the confidence of government officials in developed and developing countries, as well as international private investors and lenders. The reforms described above have been put forward in response to those concerns, with varying degrees of official sponsorship and probability of implementation.

68. Meanwhile, in several countries, most dramatically in the United States, the strategy of the international community has been attacked from both the left and right wings of the political spectrum. The passions of demonstrators in the streets of Washington, D.C., during the April 2000 meetings of the ministerial committees of the Bretton Woods institutions, on the one hand, and of conservative legislators in the United States Congress and their academic supporters, on the other hand, were expressed in very different ways; but both groups seemed to question whether the apex institutions of international financial cooperation weren't doing more harm than good. Certainly, those were extreme views; but the broad middle range of opinion globally that supports these institutions does so with less confidence than it did, say, five years ago. Indeed, deep reforms of these institutions and of other components of the international system are being discussed with considerable urgency in various policy research institutions and forums that inform this broad centre of opinion and help to shape policy, especially in developed countries, and especially in the countries that take a strong leadership role in the international institutions. This is no longer a period of "business as usual".

69. One demand of the critics has been for full institutional transparency and accountability to the public. In this regard, both IMF and the World Bank

have launched several initiatives aimed at providing the public with more information. Also, the Executive Board of IMF agreed to establish an independent evaluation office. It is recognized, however, that further steps should be taken to make the presentation of information about their operations clearer and more understandable to the public.

70. In addition, various ways have been suggested in which the process of developing IMF adjustment programmes could be made more transparent. These include suggesting that other government ministries and parliamentarians participate in programme discussions alongside finance ministry officials and central bankers, making programme documents and policy papers available to the public before they are discussed by the Executive Board, and disseminating IMF reports more widely in programme countries. One step in this direction has already been taken by the Bretton Woods institutions in building a process of consultation and consensus-building, leading to greater "ownership", as reflected in the preparation of the joint IMF/World Bank Poverty Reduction Strategy Papers and in the Comprehensive Development Frameworks of the World Bank.

71. IMF and World Bank operations are only part of the debate that has engaged the international community. The international financial architecture encompasses a larger set of entities, including the new Financial Stability Forum, as noted earlier, and the committees affiliated with BIS that deal with standards and practices of prudential regulation and supervision of financial institutions and markets. One aspect of these entities that has become controversial is that they make recommendations that are expected to be adopted, inter alia, by developing and transition economies, although they are mostly drawn up by representatives of the developed countries. This raises a concern about legitimacy, as these recommendations can be perceived as imposed from outside.[25] In this case, "ownership" is very important, as greater involvement normally leads to greater sense of commitment. There is also a concern about adequate sensitivity to distinct needs of, and constraints on, individual countries.

72. The degree of representation of developing and transition economies is greater in the governance structures of IMF and the World Bank than in FSF. Both Bretton Woods institutions group the smaller country members into constituencies, each of which selects one member to represent the constituency on the Executive Board (plus one alternate). Thus, individual members have a voice through their constituency. This notwithstanding, small countries have little practical influence on policy-making. The allocation of voting rights is governed by the manner in which equity contributions are shared among the members of each organization, which is in turn largely a function of economic strength and organization history. However, the fact that representation on the Executive Board does not necessarily reflect any more the relative systemic importance of each member is in contrast to the effort to give greater room to such voices in the ad hoc Group of 20, which the G-7 created in 1999. There is, however, a broadening view that the voting structures of the Fund and Bank should be realigned both to better reflect current economic realities and to give more representation to low-income countries. The upcoming review of the IMF's Quota formula provides an opportunity for such a realignment.

73. There is always a quandary in regard to the design of intergovernmental bodies in which each member has a right of participation in governance. Small entities can deliberate effectively, as around a table, whereas full representation of a large number of members can be somewhat unwieldy. Sometimes, the principle of "subsidiarity" can usefully limit what needs to be addressed at global level, or sub-groupings of the whole membership can deliberate first in decentralized forums and the group views can then be represented in the global forum. On both counts, it follows that, along with global institutions, stronger regional and subregional bodies can play a significant role in the globalizing world economy.[26] It has been suggested, for example, that a more decentralized policy-making process might be conceived wherein regional forums would help prepare for discussion by representatives in global forums and thus facilitate wider participation in the discussion of global issues.

74. Also, regional cooperation could supplement the global cooperative framework, for example, in strengthening surveillance and creating or strengthening short-term financing facilities for participating countries in times of crisis. Indeed, a few facilities of this sort already exist, such as the Arab Monetary Fund and the Fondo Latinoamericano de Reservas. Regional groupings may better focus on individual countries and put "peer pressure" behind

their recommendations. Enhanced mutual surveillance and policy dialogue might place countries in a region in a much better position to monitor financial vulnerabilities and administer schemes for mutual assistance. In the light of the above, the May 2000 decision by East Asian finance ministers to enhance regional monetary cooperation arrangements can be seen as a very positive development.[27]

VI. Placing a strengthened and more stable financial system in the international agenda

75. This report has reviewed the main recent developments in international financial reform. It appears, all in all, that there is a widespread willingness of policy makers to consider and adopt significant changes in the international financial architecture. There is still, however, considerable work to complete. Several proposals were noted that warrant further consideration by the international community.

76. These proposals all seek to build a strengthened and more stable international financial system, responsive to the priorities of growth and development and to the promotion of economic and social equity. The proposals fall into a number of key areas, which can be set out in the form of an agenda:

(a) Crisis prevention:

(i) Robust domestic financial sectors everywhere;

(ii) Sustainable exchange-rate and capital-account arrangements;

(iii) Focused and effective multilateral surveillance;

(b) Crisis resolution:

(i) Modalities for involving the private financial sector;

(ii) A lender-of-last-resort mechanism for emergency liquidity creation;

(c) Institutional structure:

(i) Subsidiarity: building regional and subregional bodies;

(ii) Governance: effective participation of all countries in rule-making.

77. Reform of the international monetary and financial system has reached the international political agenda. This is an extremely sensitive moment, as many Governments have deep interests at stake, as has the private sector around the world. Civil society has raised important political, ethical and developmental considerations as well. Reflecting this fact, the issue warrants discussion from multiple perspectives and in multiple forums. Discussion is an essential part of consensus-building, which is needed, and it is surely best to include the views of all relevant stakeholders in the deliberations.

78. The United Nations is a natural forum for such considerations. In this regard, Member States recently reached an important agreement to include systemic issues among the broad themes of the preliminary, indicative agenda of the preparatory process of the high-level international intergovernmental event on financing for development and the event itself.[28] This provides a unique opportunity to bring the world's political decision makers together to reach a new understanding that can shape the future of financing for development.

Notes

[1] The concerns expressed in various paragraphs of the resolution to protect social expenditure, strengthen social safety nets and promote economic and social equity in the global economy, as well as human rights, are addressed in other reports to the fifty-fifth session of the General Assembly, notably that on the outcome of the twenty-fourth special session of the Assembly held from 26 to 30 June 2000 to review the implementation of the commitments made at the 1995 World Summit for Social Development (A/55/344).

[2] For more detail, see the report of the Secretary-General to the fifty-fifth session of the General Assembly entitled "Update on the implementation of the Declaration on International Economic Cooperation, in particular the Revitalization of Economic Growth and Development of the Developing Countries, and implementation of the International Development Strategy for the Fourth United Nations Development Decade" (A/55/209).

[3] See the report of the Secretary-General to the fifty-fifth session of the General Assembly on "Enhancing international cooperation towards a durable solution to the external debt problem of developing countries".

[4] For details on the African situation, see "Ministerial statement", ECA Joint Conference of Ministers of

Finance and Ministers Responsible for Economic and Social Development and Planning, Addis Ababa, 6-8 May 1999.

[5] For details, see *World Economic and Social Survey 2000* (United Nations publication, Sales No. E.00.II.C.1), chaps. I-III.

[6] Ibid., chap. I.

[7] While the effect of exchange-rate volatility on overall trade volumes appears to be rather small, large exchange-rate swings seem to create substantial sectoral adjustment costs (see Michael Mussa and others, *Exchange Rate Regimes in an Increasingly Integrated World Economy* (Washington, D.C., International Monetary Fund, April 2000), p. 19).

[8] The necessary role of government in strengthening a market-based financial sector is a theme of part two of *World Economic and Social Survey, 1999* (United Nations publication, Sales No. E.99.II.C.1), entitled "Financial development in the globalizing world".

[9] Recently, IMF has begun to use the Basel Core Principles of Banking Supervision and the accompanying Methodology (see below) to assess countries' observance of standards of banking supervision, mostly in the context of a more comprehensive assessment of the country's financial risks and vulnerabilities, with a view to helping countries make their financial systems more robust. There is some controversy, however, over the extent to which IMF should expand its surveillance over financial systems. Some aver, for example, that core competence in regulatory matters resides elsewhere.

[10] There have also been proposals to introduce capital requirements on the short-term exposure of borrowing banks, in other words, to make the required level of bank capital depend not only on the nature and size of the bank's assets, but also on the nature of its funding.

[11] There is also a concern that ratings under the new Basel system might become systematically over-optimistic. Today, when a bond is rated, it is said that the borrower wants a high rating to reduce the interest charge, while the lender would prefer a lower rating to justify a higher interest charge. Were a bank loan to be rated, the bank as well as the borrower might prefer a higher rating, as the bank would have to hold less capital if the rating was high.

[12] In some countries, however, ratings agencies are formally accredited, as in the United States where the Securities and Exchange Commission has a rigorous process for approval of such agencies.

[13] This is part of a broad concern in international regulatory discussion with respect to establishing a "level playing field" in order that competitors may not gain special advantage owing to place of incorporation or formal form of financial institution.

[14] This notwithstanding, although all Basel Committee members are developed countries, the Core Principles were prepared in a group comprising emerging economies as well as members. Moreover, both the Core Principles and the Methodology were put out for consultation worldwide and much useful feedback from developing countries was received and taken into account in preparation of the final version.

[15] Opponents of such measures say they risk introducing unnecessary distortions. Proponents acknowledge they are blunt instruments, but say they can help in a variety of developing-country environments, especially when they are set to bind only intermittently, for example, in the case where a financial bubble is building.

[16] This point was driven home by the experience of many foreign investors in Russian assets during the rouble collapse of August 1998. They thought they had addressed their exchange-rate risk, as they had hedged their currency exposure through rouble/dollar swaps with Russian banks. The possibility that those banks might not be allowed to honour their contracts and reverse the swaps on a timely basis was evidently not considered. In the event, the investors discovered they had enormous currency exposure.

[17] See, for instance, "Debt and reserve-related indicators of external vulnerability", IMF Staff paper, 23 March 2000, available on the IMF web site at www.imf.org/external/ap/pdr/debres/index.htm.

[18] See Howell H. Zee, "Retarding short-term capital inflows through withholding tax", IMF Working Paper No. WP/00/40, March 2000.

[19] Mervyn King, Deputy Governor of the Bank of England, was quoted in the *Financial Times* (16 May 2000) as saying: "In terms of private sector involvement, we haven't got much beyond the articulation of the phrase 'private sector involvement'."

[20] UNCTAD has proposed that the trigger mechanism be agreement by an independent panel of individuals constituted for the purpose (see *Trade and Development Report, 1998* (United Nations publication, Sales No. E.98.II.D.6), part one, chap. IV, sect. B.5).

[21] For a comprehensive review of some of these proposals, see "Safeguarding against crisis: the near-term agenda", in *Global Development Finance 2000*, vol. I (Washington, D.C., World Bank, April 2000), pp. 97-118.

[22] The cost of reserves is the opportunity lost by holding the funds rather than using them, for example, for investment and imports (for additional considerations, see *Trade and Development Report, 1999* (United

Nations publication, Sales No. E.99.II.D.1), part two, chap. V, sect. C.2).

[23] This parallels the "back to basics" concern regarding IMF surveillance noted earlier. Indeed, loans given to the East Asian countries during their recent crises included between 50 and 80 conditions, compared with less than a dozen on typical Fund programmes 20 years before (see *The Future Role of the IMF in Development*, report of a Task Force of the Overseas Development Council (Washington, D.C., April 2000), p. 8).

[24] See Louis M. Goreux, *Compensatory Financing Facility*, IMF Pamphlet Series, No. 34 (Washington, D.C., 1980).

[25] This point was argued, for example, by the Finance Minister of Italy and echoed by the Development Cooperation Ministers of Germany and the Netherlands at the special high-level meeting of the Economic and Social Council with the Bretton Woods institutions on 18 April 2000 (for a summary of this discussion, see E/2000/79, annex).

[26] For an elaboration of this view, see the updated report of the Executive Secretaries of the regional commissions, as contained in an addendum to this report (A/55/187/Add.1).

[27] In this case, regional policy dialogue is to be strengthened, inter alia, through stepped-up capital flow monitoring, while the regional self-help and support mechanism will be bolstered through an expanded swap arrangement among the member countries of the Association of Southeast Asian Nations (ASEAN) and a network of bilateral swap and repurchase facilities among ASEAN countries, China, Japan and the Republic of Korea; in addition, a network of ASEAN research and training institutions is to be established with the support of China, Japan and the Republic of Korea (see Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting, Chiang Mai, Thailand, 6 May 2000). This is, moreover, only one of several Asian cooperative mechanisms for economic and financial monitoring (for more detail, see *Economic and Social Survey of Asia and the Pacific, 2000* (ST/ESCAP/2043), part two, pp. 218-228 and 236-238).

[28] See A/AC.257/L.../Rev.1, adopted 2 June 2000.